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Article

Progam report: Monetary economics

NBER Reporter Online

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National Bureau of Economic Research (NBER), Cambridge, Mass.

Suggested Citation: Mankiw, Gregory N. (1999) : Progam report: Monetary economics, NBER Reporter Online, National Bureau of Economic Research (NBER), Cambridge, MA, Iss. Spring 1999, pp. 1-4

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https://hdl.handle.net/10419/67007

NBER Reporter

NATIONAL BUREAU OF ECONOMIC RESEARCH

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SPRING 1999

In This Issue

Program Report

Monetary Economics

N. Gregory Mankiw

Every consumer of the news appreciates the importance of monetary economics. Almost every day, the newspaper contains stories about inflation, deflation, or the next policy move by the Federal Reserve System.

The NBER's Program on Monetary Economics encourages systematic research to better understand monetary policy and related issues in macroeconomics. Although program members share this common goal, they display great diversity in interests, methods, and conclusions. In this brief essay, I describe several recent studies. Although the breadth of program research prevents me from being comprehensive, I offer a glimpse at the kinds of work that this NBER program has been promoting. A complete list of downloadable Working Papers produced by the Monetary Economics Program since 1995 is available at the NBER's Web site, **www.nber.org**—click on the home page option "Latest Working Papers by Program" and then select "Monetary Economics." In addition to the many Working Papers written by members of the program, three separate volumes summarize larger research projects sponsored by the Monetary Economics Program: *Monetary Policy,* edited by N. G. Mankiw (University of Chicago Press, 1994); *Reducing Inflation,* edited by C. Romer and D. Romer (University of Chicago Press, 1997); and *Monetary Policy Rules,* edited by J. B. Taylor (University of Chicago Press, 1999).

The Effects of Monetary Policy

How does monetary policy affect the economy? This question, more than any other, is at the center of research in the NBER's Program on Monetary Economics. Many papers have attempted to answer this question using various datasets and research methodologies.

In one recent study, Ben S. Bernanke and Ilian Mihov use a statistical method called "structural vector autoregression" to examine two classic propositions about the effects of monetary policy. The first proposition—the liquidity effect—states that monetary expansions lower nominal interest rates

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in the short run. The second proposition—long-run neutrality—states that monetary policy does not affect real variables (such as employment and production) in the long run. Bernanke and Mihov report that the evidence is consistent with both of these propositions.[1]

Laurence M. Ball reaches a very different conclusion about the long-run effects of monetary policy in his paper "Disinflation and the NAIRU." Ball examines the unemployment experience in a large number of OECD countries during the 1980s. He reports that countries with larger decreases in inflation and longer disinflationary periods have larger increases in the natural rate of unemployment. This finding suggests that in some countries monetary policy can have long-lasting effects on employment and production.[2]

Another paper that reports long-lasting effects of monetary policy, but of a very different kind, is "Monetary Policy and the Well-Being of the Poor," by Christina D. Romer and David H. Romer. This study finds that a cyclical boom created by expansionary monetary policy improves conditions for the poor in the short run, but that low inflation is associated with improved well-being of the poor in the long run. In contrast to Ball, who finds that reducing inflation may permanently raise unemployment, Romer and Romer find that reducing inflation can permanently improve conditions for the most needy members of society.[3]

Inflation Targeting as a Policy Framework

Members of the Program on Monetary Economics are interested not only in the effects of monetary policy but also in evaluating alternative ways of conducting that policy. Throughout the 1990s, many of the world's central banks—including

those of Australia, Canada, Finland, Israel, New Zealand, Spain, Sweden, and the United Kingdom—have adopted some form of an inflation target. Because of the widespread practical interest in this policy, many NBER researchers have recently studied this topic.

What is inflation targeting? Sometimes it merely takes the form of a central bank announcing its long-run policy intentions. Other times it takes the form of a national law that stipulates explicitly the goals of monetary policy. For example, the Reserve Bank of New Zealand Act of 1989 told the central bank "to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices." The act conspicuously omits any mention of any other competing objective, such as stability in output, employment, interest rates, or exchange rates. Although the U.S. Federal Reserve System has not adopted inflation targeting, some members of Congress have proposed bills that would require it to do so.

It is tempting to interpret inflation targeting as a type of precommitment to a policy rule. Yet according to a paper by Bernanke and Frederic S. Mishkin, this interpretation would not be completely accurate. In all the countries that have adopted inflation targeting, central banks are left with a fair amount of discretion. Inflation targets are usually set as a range—an inflation rate of 1 to 3 percent, for instance—rather than as a particular number. Thus the central bank can choose where in the range it wants to be. In addition, the central banks are sometimes allowed to adjust their targets for inflation, at least temporarily, if some exogenous event (such as an easily identified supply shock) pushes inflation outside of the range that was previously announced.

In light of this flexibility, what is the purpose of inflation targeting? Although inflation targeting does leave the central bank with some discretion, it also constrains how this discretion is used. When a central bank is told to "do the right thing," it is hard to hold the central bank accountable, because people can argue forever about what the right thing is in any particular circumstance. By contrast, when a central bank has announced an inflation target, the public can more easily judge whether the central bank is meeting that target. Thus, although inflation targeting does not tie the hands of the central bank, it does increase the transparency of monetary policy and, by doing so, makes central bankers more accountable for their actions.[4]

Monitoring Inflation

Monetary policymakers and private forecasters monitor inflation closely. Each monthly release of the consumer price index is examined in detail to see if it contains warnings of the beginning of an inflation problem. But what data are best used for this purpose? That is exactly the question taken up by Michael F. Bryan, Stephen G. Cecchetti, and Rodney L. Wiggins II in their paper "Efficient Inflation Estimation."

Policymakers and forecasters have long known that monthly inflation data are noisy. As a result, they often look at some measure of "core inflation," which is usually defined as inflation excluding specific, volatile sectors such as food and energy. By contrast, Bryan, Cecchetti, and Wiggins study the use of "trimmed means" to measure the underlying inflation trend. A trimmed mean for inflation takes the average of all price changes excluding those price changes in the tails of the distribution. They find that these trimmed means provide a superior way of gauging the long-run inflation trend.[5]

How People View Inflation

Of all the problems that economists study, inflation ranks high in the public's interests. Indeed, according to Robert J. Shiller, "inflation" is the economic term that shows up most often in the media, far ahead of second-place finisher "unemployment" and third-place finisher "productivity."

Why are people so concerned about inflation? In his paper "Why Do People Dislike Inflation?" Shiller tries to answer this question directly by asking people about their attitudes toward inflation. He also compares public attitudes to those of professional economists and finds some striking differences between the two groups.

Shiller asked people whether their "biggest gripe about inflation" was that "inflation hurts my real buying power, it makes me poorer." Seventy-seven percent of the public agreed with this statement, compared with only 12 percent of economists. Shiller also asked, "Do you agree that preventing high inflation is an important national priority, as important as preventing drug abuse or preventing deterioration in the quality of our schools?" Fifty-two percent of the public fully agreed with this view, compared with only 18 percent of economists.

Another question from the Shiller survey is: "Do you agree with the following statement, 'I think that if my pay went up I would feel more satisfaction in my job, more sense of fulfillment, even if prices went up just as much'?" Forty-nine percent of the public fully or partly agreed with this statement, compared to 8 percent of economists.[6]

How should these survey results be interpreted? Although they are intriguing, the bottom line is not completely clear. Certainly, economists think very differently about

inflation than the public does. Whether that means the public needs to listen more carefully to monetary economists, or vice versa, remains an open issue.

Future Directions

Predicting the direction of research is about as easy as predicting the direction of the stock market. And for much the same reason: if people could tell where we were going, we would be there already. But like the inevitability of stock-market fluctuations, there is no doubt that research on monetary economics will remain active. As Japan wrestles with deflation and a potential liquidity trap, Russia copes with fiscal insolvency and the possibility of hyperinflation, and the United States enjoys an era of approximate price stability, monetary topics are everywhere to be seen. In every case, NBER monetary researchers are sure to be there as well.

[1] *B. S. Bernanke and I. Mihov, "The Liquidity Effect and Long-Run Neutrality," NBER Working Paper No. 6608, June 1998.*

[2] *L. M. Ball, "Disinflation and the NAIRU," NBER Working Paper No. 5520, March 1996.*

[3] *C. D. Romer and D. H. Romer, "Monetary Policy and the Well-Being of the Poor," NBER Working Paper No. 6793, November 1998.*

[4] *See B. S. Bernanke and F. S. Mishkin, "Inflation Targeting: A New Framework for Monetary Policy?," NBER Working Paper No. 5893, July 1997. Other papers on inflation targeting include B. T. McCallum, "Inflation Targeting in Canada, New Zealand, Sweden, the United Kingdom, and in General," NBER Working Paper No. 5579, February 1998; F. S. Mishkin and A. S. Posen, "Inflation Targeting: Lessons from Four Countries," NBER Working Paper No. 6126, February 1998; G. D. Rudebusch and L. E. O. Svensson, "Policy Rules for Inflation Targeting," NBER Working Paper No. 6512, April 1998; and L. E. O. Svensson, "Inflation Targeting as a Monetary Policy Rule," NBER Working Paper No. 6790, November 1998.*

[5] *M. F. Bryan, S. G. Cecchetti, and R. L. Wiggins II, "Efficient Inflation Estimation," NBER Working Paper No. 6183, September 1997.*

[6] *R. J. Shiller, "Why Do People Dislike Inflation?," NBER Working Paper No. 5539, April 1996.*

Research Summaries

Understanding Aggregate Fluctuations: The Importance of Building from Microeconomic Evidence

John C. Haltiwanger*

In recent research using longitudinal establishment-level data, a pervasive finding is that idiosyncratic factors dominate the distribution of growth rates of output, employment, investment, and productivity across establishments. Seemingly similar plants within the same industry exhibit behave quite differently in terms of real activity at cyclical and longer-run frequencies. Even in the fastest-growing industries, a significant fraction of establishments decline substantially; similarly, a large fraction of establishments in the slowest-growing industries grow dramatically. During severe recessions virtually all industries decline, but within each industry a substantial fraction of establishments grow. Likewise, during robust recoveries, a substantial fraction of establishments contract. Simply put, the underlying gross microeconomic changes in activity dwarf the net changes that we observe in published aggregates.

The tremendous observed within-sector heterogeneity raises a variety of questions for our understanding and measurement of key macro aggregates. Much of macroeconomic research and our measurement of aggregates is predicated on the view that building macro aggregates from industry-level data is sufficient for understanding the behavior of the macro economy. The implicit argument is that, at least at the detailed industry level, the assumption of a representative firm or establishment is reasonable.

The finding of tremendous within-industry heterogeneity is not by itself sufficient to justify abandoning this useful assumption. There is undoubtedly considerable canceling out of the impact of idiosyncratic shocks (for example, taste, cost, and technology) that underlie the heterogeneous fortunes across individual producers. Evidence from recent establishment-level studies of em-

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